

## A Comparison of Retail Franchises, Independent Businesses, and Purchased Existing Independent Business Startups: Lessons From the Kauffman Firm Survey

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### **Abstract:**

Franchising is a major economic powerhouse. Though research has been conducted on franchising from multi-disciplinary viewpoints, no study has compared retail franchises, independent businesses, and purchased existing independent businesses in the startup phase. This study utilized data from the U.S.-based Kauffman Foundation Firm Survey and examined major variables that would more likely influence survival-business type, ownership, owner-operator combinations, total revenue, labor intensity, profit and loss, and prior ownership experience. Our findings indicate that franchises differ considerably from new, independent businesses in most respects but are similar to purchased existing independent businesses. The overall results confirm prior findings that franchises have impediments that may affect their survival in the first year of operation and that some of the advantages of choosing a franchise over another form of business that have been sighted by the industry may not be completely valid.

**Keywords:** business startups; entrepreneurship; firm survival; franchising

### **Article:**

## **INTRODUCTION**

Franchising is a major economic powerhouse. Franchising in the United States is so widespread that 1 of every 12 retail businesses is a franchised business, and more than 8 million people are employed in these franchised businesses (International Franchise Association [IFA], 2006). The IFA (2005) reported that the direct contributions to the U.S. economy include 11,029,206 jobs, \$278.6 billion in payroll, \$880.9 billion in output, and 909,253 establishments. Total contributions to the U.S. economy attributable of franchised businesses are 20,974,636 jobs, \$660.9 billion in payroll, and \$2.31 trillion in output. This means that franchised businesses use products and services from related businesses and therefore provide income to their workers and owners, who spend their income with other parties, and the cycle repeats.

Yet there is a difference between where the overall franchise industry is now in terms of success and generalizing this to franchises in the startup phase. The promotional literature that has long been used in the industry touting a “tried and true” or less risky method of starting a business has been brought into question by a number of academic studies, and there is an overall perception that franchising success statistics have long been over-reported (Piling, 1991). Inaccurate, incomplete data have long plagued the franchise industry (Cross, 1998). The franchise industry has suffered from being more protective and secretive than other industries, so data are limited, especially data over time that would prove or disprove whether franchising leads to higher success rates (Hoy, 1994). What has been concluded in these studies is that it depends on what we are

comparing and at what point in time—the methodology and the definitions behind failure and survival (Holmberg & Morgan, 1996). For an entrepreneur contemplating starting a new business, all questions lead to “Is my chance of being successful and surviving past the startup phase greater with a franchise or with another form of business?”

To answer this question, research first must compare franchising in the startup phase with other, specific forms of organizations that are available to the entrepreneur rather than a generic non-franchise catchall category wherein all other forms are grouped into one. This study seeks to fill this gap by comparing franchised businesses to independent businesses and purchased existing independent businesses in the startup phase. Previous studies did not differentiate between new and purchased existing independent businesses. Both purchased existing businesses and franchises could be considered proven business models as compared to new independent businesses.

The purpose of this research was to examine organizational forms in the startup phase by examining a sample of 4,928 franchises, independent businesses, and purchased existing independent businesses that began in the United States in 2004, 1 year after their initial startup phase. The article proceeds in the following manner. The next section describes franchising and explains why studying this organizational form compared to other organizational forms is useful to understanding firm survival and growth. The section develops an explanation of why franchising should be compared to specific organizational forms rather than grouping the other organizational forms into one non-franchising category based on agency theory. Survival and success of franchisees and franchisors are examined. The third section of the article describes the methodology used to test this explanation. The fourth section describes the results of this analysis. The fifth section discusses conclusions and implications from the study.

## **THEORETICAL FRAMEWORK & HYPOTHESES**

### **The Franchisee as Entrepreneur**

Dant (2008), Cochet, Dormann, and Ehrmann (2007), and Welsh (2002), among others, point out that the first step in answering this question, in part, is to develop a better understanding of franchising from the franchisee as entrepreneur standpoint. While a few studies have focused on the franchisee as entrepreneur perspective (i.e., Dickey, 2003; Frazer & Winzar, 2005; Gr ün hagen & Dorsch, 2003; Gr ün hagen & Mittelstaedt, 2005; Hoy, Stanworth, & Purdy, 2000; Weaven & Frazer, 2003; Weaven, Grace, & Manning, 2009), these studies are somewhat rare. The factors that are important to the franchisee are survival, profit, and growth. While franchisors want the same for their franchisees, they often have other competing interests that may take a higher priority, such as shareholder value, profitability, and brand recognition.

The major reviews of the franchising literature bring this fact to the forefront. Elango and Fried; Young et al. (2000); and Runyan and Droge (2008) conducted the only major reviews of the franchising literature. Elango and Fried and Young et al. found a vast majority of the studies written from the franchisor perspective. Most of these studies focused on the role of the franchisee in terms of achieving the operational goals of the franchisor so control and power were tantamount. Since then, major research in the field has focused on franchisor-franchisee relationships. If the franchisor can control the franchisee, the franchisor will be able to successfully implement its marketing goals (Carman & Klein, 1986), which is often accomplished through the pricing of franchise rights (Kaufmann & Dant, 2001). Tikoo (2002) and Paik and Choi (2007) focused on coercion and control issues by the franchisor and the amount of freedom given to franchisees. Yet, little is known from the standpoint of the franchisee.

What have appeared in the literature to a limited extent are comparison studies between franchisees as entrepreneurs and independent business owners. Runyan and Droge (2008) found seven major studies that

compared independent versus franchised small businesses in a review of 20 years of research on small, independent retailers using the Small Business Administration definition. Withane (1991) studied success factors for franchisees versus independent business owners and found that risk taking was most important for success. Knight (1984) found that independent business owners were more self-reliant, highly motivated, and independent-minded than franchisees. The Bronson and Morgan (1998) comparison showed that economies of scale accounted for increased efficiency of franchisees over independent businesses. Litz and Stewart (1998) found that retail franchises performed a little better except in highly competitive environments. Kalnins and Mayer (2004) discovered that multiple units benefit from an owner's congenial experience whether they were or were not franchised locations and that local experience reduced failure rates. Sanghavi (1991) concluded that retail franchises allow for defense of market share for small and large retailers. None of these studies differentiated between the various types of independent businesses and examined them in comparison to franchises. For the most part, studies compared franchises to a catchall category of non-franchises, grouping all other types of businesses into one category. However, they are important because they compare either the organizational form or the entrepreneur as franchisee to other types of business owners.

## Startup Survival and Success Rates

Until the 1990s, the overarching belief was that franchised businesses had a much greater chance of success than starting an independent business. Comparison studies were conducted by the Department of Commerce and, when they were discontinued, the IFA commissioned a number of independent studies that found the same. Timothy Bates's 1995 seminal *Journal of Small Business Management* study compared U.S.-franchised to non-franchised firms' survival rates and found that independent businesses had a higher survival rate (1995b). The database utilized in this study was compiled by the U.S. Bureau of the Census in 1992. In a related study published in *Small Business Economics* (1995a), Bates found that independent business startups were more profitable and their survival prospects better than those of franchises, although the franchises were larger-scale and better capitalized. These studies opened the debate as to how much advantage, if any, a franchise has over an independent business in terms of success and survival, although one would logically conclude that the franchisee would have an advantage because of access to managerial assistance and training, financial capital, and markets through advertising, brand familiarity, and trademarks. Bates took the next step in a study published in the *Journal of Business Venturing* (1998) and analyzed restaurant data methodologically in two distinct ways to look at survival patterns between independent businesses and franchisees. He found that franchise units had better survival rates than independent businesses using one method and that new franchised businesses formed without franchisor-ownership were less likely to stay open. In fact, in his study, 84% of the new franchises were part of multi-establishment corporations, and just a handful were newly established corporations. The strength behind these new franchisee unit openings made the difference in their survival. The study concluded that entrepreneurs do not necessarily improve their survival chances by purchasing a franchise versus an independent business.

Stanworth, Purdy, Price, and Zafiris (1998) also compared small businesses that were franchised in terms of survival and explored the reasons for their survival. They concluded that if all franchise exits were counted as "franchise deaths," franchising is riskier than independent businesses in the startup phase. Their follow-up study looked at franchisors in the startup phase and found the same high risk. Shane (1996) found that new organizations utilizing a hybrid growth strategy that included franchising increased their survival and growth, although most new franchising systems do not survive past 10 years.

The age of the franchise system; entry costs (Stanworth, Purdy, English, & Willems, 2001; Frazer & Winzar, 2005); size (Franzer & Winzar); early legitimacy and efficiency (Shane & Foo, 1999); market entry and the pioneering advantage (Juste, Lucia-Palacios, & Polo-Redondo, 2009); expansion strategies (Carney & Gedajlovic, 1991); hybrid arrangements (Shane, 1996); exclusive territories (Azoulay & Shane, 2001); level of conflict with franchisees (Frazer & Winzar); and the timing of buy-back decisions of franchised outlets (Brickley, Dark, & Weisback, 1991) all impact franchisor survival and thus impact survival for the entrepreneur

as franchisee startup. What is missing is a comparison of franchises in the startup phase to other forms of businesses. This study seeks to fill this gap by comparing franchised businesses to independent businesses and purchased existing independent businesses in the startup phase. Previous studies did not differentiate between new and purchased existing independent businesses. Both purchased existing businesses and franchises could be considered proven business models as compared to new independent businesses.

## Agency Theory

There has been a considerable body of research that has examined ownership types or structures, including the use of operating and non-operating partners; company-owned outlets to franchised outlets based on agency theory (Brickley & Dark, 1987; Caves & Murphy, 1976; Dant, Perrigot, & Cliquet, 2008; Lafontaine & Kaufmann, 1994; Oxenfeldt & Kelly, 1969; Rubin, 1978); and mixed ownership (Bradach, 1997; Bradach & Eccles, 1989; Burkle & Posselt, 2008; Dant & Kaufmann, 2003; Harrigan, 1984). Agency theory provides a theoretical basis for this study because franchising is a hybrid organizational form that allots rights of ownership to the managers of outlets. Based on the ownership literature, the cost of franchises, compared to a new or purchased independent business that may have terms that are negotiable, may not vary and because there is greater risk in owning one franchised outlet rather than spreading the risk over a number of outlets (Rubin, 1978):

H1a: Franchisees are more likely to have multiple owners than new independent businesses.

H1b: Franchisees are more likely to have multiple owners than purchased independent businesses.

H1c: Franchisees are more likely to have multiple owner-operators than new independent businesses.

H1d: Franchisees are more likely to have multiple owner-operators than purchased independent businesses.

Our second hypothesis suggests that revenue is related to type of business startup and wage expenses. Based on a unique combination of tangible and intangible assets that creates a competitive advantage for franchisees (Hoffman & Preble, 2003) and by the franchisor passing along economies of scale in marketing, production, and administration in return for the franchise fee (Carney & Gedajlovic, 1991; Caves & Murphy, 1976):

H2a: Franchisees will have significantly larger revenues than new independent businesses.

H2b: Franchisees will have significantly larger revenues than purchased independent businesses.

H2c: Franchisees will have significantly lower relative wage expenses than new independent businesses.

H2d: Franchisees will have significantly lower relative wage expenses than purchased independent businesses.

The third hypothesis explores profit between the three types of businesses, and the fourth and fifth hypotheses are reflected in the bottom-line results. Prior findings are mixed in this regard. Economies of scale can account for increased efficiency of franchisees over independents (Bronson & Morgan, 1998) and also lower transaction costs (Norton, 1988). The presence of countervailing forces (Pfeffer & Salancik, 1978) suggests that the costs involved in franchising should be accompanied by measurable results so that franchisees perform significantly better than independent retailers (Litz & Stewart, 1998):

H3a: Franchisees are more likely to have a profit in their first year than new independent businesses.

H3b: Franchisees are more likely to have a profit than purchased independent businesses.

The final hypothesis considers the likelihood that the owner is a serial entrepreneur, defined in this study as one who has owned previous businesses. Based on the success factors for franchisees versus independent businesses, risk taking was the most important factor to the success of a business (Withane, 1991). Ozanne and Hunt (1971), Felstead (1993), and Stanworth and Kauffman (1996) clearly found that independent self-employment was key to considering a franchise. As franchising is touted to reduce business risk compared to independent businesses:

H4a: Franchisees are more likely to be serial entrepreneurs than new independent business owners.

H4b: Franchisees are more likely to be serial entrepreneurs than purchased independent business owners.

## METHODOLOGY

### Sample

The Kauffman Firm Survey (KFS) is the largest longitudinal study of new businesses ever embarked upon (DeRoches, Robb, & Mulcahy, 2009). KFS is a panel study of 4,928 new businesses founded in 2004 that mirrored the true population according to Dunn & Bradstreet. Data were collected using both Web-based and computer assisted telephone interviews that asked many measures of specificity; including the nature of new business formation activity (franchisees, new independent businesses, or purchased independent businesses); characteristics of the strategy, offerings, and employment patterns of new businesses; the nature of the financial and organizational arrangements of these businesses; and the characteristics of their founders/partners. As expected, the majority of the businesses in the sample (4,570 or 92.1%) consisted of new, independent businesses created by a single or team of person, whereas 240 (or 5.1%) were purchased existing businesses and 109 (or 2.6%) were franchises. The franchise sample (2.6% of the total KFS dataset) closely matches the reported total franchise to new startup businesses ratio of 3.3% reported in the economic research study conducted by PricewaterhouseCoopers for the IFA Educational Foundation (2008).

The use of the dataset was made possible as part of the Data Enclave agreement between one of the researchers, and the Erwin Marion Kauffman Foundation and National Opinion Research Center. Ranges could not be reported, and any cell containing fewer than 10 cases had to be combined or suppressed to protect the confidentiality of the participants. The researchers elected to recode some of the variables in an effort to keep all respondents as part of this research analysis as a result none of data cells were suppressed. The recoding affected less than 1% of the sample.

### Analysis

In this study, we conducted cross-tab analyses of the following variables to identify possible relationships among variables using three types of businesses: franchises (labeled as franchisees in this research); new independent businesses created by one or more individuals; and purchase of an existing business (labeled as purchased businesses in this research). This variable was used as our control variable.

### OWNERSHIP

Panel study participants were asked how many individuals or entities owned the business by the end of the year. The respondents were able to select up to 100 individuals or entities. Researchers recoded the dataset by labeling the businesses that had one owner as *solo* versus labeling as *partners* all businesses that had one or more partner.



OWNER-OPERATOR

Panel study participants were asked how many individuals or entities that owned the business by the end of the year also helped run the business. The respondents were able to select up to 100 individuals or entities. Researchers recoded the dataset by labeling the businesses that had one owner/operator as solo versus labeling as partners all businesses that had one or more owner/operator.

TOTAL REVENUE

Each panel study participant was asked what the total revenue was for the business for the completed year. Some respondents offered actual revenue amounts whereas the majority provided ranges (\$500 or less; \$501 to \$1,000; \$1,001 to \$3,000; \$3,001 to \$5,000; \$5,001 to \$10,000; \$10,001 to \$25,000; \$25,001 to \$100,000; \$100,001 to \$1,000,000; or \$1,000,001 or more). Following the convention of Kim, Keister, and Aldrich in the *Handbook of Entrepreneurial Dynamics* (2004) for assigning values to ranges of financial information, we assigned midpoints except for data points greater than \$1,000,000, which were coded as missing. The new variable combined reported revenue amounts or midpoints as a continuous variable.

LABOR INTENSITY

Total labor cost variable is created by recoding the wage expenditure variable using the same method and reasoning as total revenue describe heretofore. Labor intensity was then generated by dividing the total labor cost associated with operating the business by the total revenue of the first year as reported by respondents. The variable is continuous in nature with a range of 0% to 1% or 0% to 100%.

PROFIT AND LOSS

Panel study participants were asked whether they had a reported profit or loss on their income statements for the previous year. The respondents recorded the dollar amount in terms of net profit after expenses and taxes were paid.

PRIOR OWNERSHIP

Finally, the survey instrument directed the panel study participants to disclose prior business ownership. The respondents were asked to indicate whether they had previous ownership experience.

RESULTS

Our first hypotheses predicted that franchisees are less likely to be solitary owners than other types of new startups. As shown in Table 1, we found support only for Hypothesis 1a ( $\chi^2 = 15.92, p < .01$ ), where franchisees were less likely (45.57%) to be solitary owners than new independent businesses (67.07%). There was no significant group difference ( $\chi^2 = .16, p = .68$ ) between franchisees (45.57%) and purchased businesses (48.51%).

TABLE 1 Results for Indicator Variables, Testing Hypotheses 1, 3, and 4

Hypothesis number	Hypothesis variable	Franchise businesses	Purchased businesses	Chi-square	New businesses	Chi-square
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Note. All chi-square comparisons are made to franchised businesses.

\* $p < .05$ ; \*\* $p < .01$ ; \*\*\* $p < .001$ .

1a, 1b                      Owner Partner

**TABLE 1 Results for Indicator Variables, Testing Hypotheses 1, 3, and 4**

Hypothesis number	Hypothesis variable	Franchise businesses	Purchased businesses	Chi-square	New businesses	Chi-square
1c, 1d	Percent Yes	54.43%	51.49%	0.172	32.93%	15.92***
	Frequency Yes	43	69		892	
	Owner-Operator Partner					
	Percent Yes	38.46%	42.54%	0.3385	26.32%	5.72*
3a, 3b	Frequency Yes	30	57		713	
	Profit					
	Percent Yes	30.38%	44.62%	4.1769*	48.47%	10.0541***
4a, 4b	Frequency Yes	24	58		1,280	
	Prior Experience					
	Percent Yes	43.04%	41.79%	0.0317	43.12%	0.00
	Frequency Yes	34	56		1,169	

We also considered whether franchisees differed from new independent businesses and purchased businesses in whether they were solitary owner-operators. Ownership may provide insight primarily into capital requirements, whereas owner-operator may provide insight into management considerations. We found support for Hypothesis 1c that franchisees are less likely to be solitary owner/operators than new independent businesses. Hypothesis 1d was not supported: Franchisees are less likely to be solitary owner/operators than purchased independent business owners. Table 1 shows that franchisees are less likely to be solo owner-operators than new independent business owners (38.46% versus 26.32% have an other owner-operator partner;  $\chi^2 = 5.71$ ,  $p < .05$ ); however, there was no significant difference between franchisees and purchased business owners concerning solitary owner-operators (38.46% versus 42.54% had another owner-operator partner;  $\chi^2 = 0.34$ ,  $p = .56$ ).

We predicted that franchisees were more likely to have larger revenues than new independent businesses or purchased independent businesses. Table 2 shows a significant difference between franchisees and new independent businesses ( $F = 29.64$ ,  $p < .01$ ). Franchisees were less likely to have larger revenues than purchased independent businesses ( $F = .02$ ,  $p = .89$ ; see Table 2).

**TABLE 2 Results of ANOVA for Hypothesis 2**

**Hypothesis** **Hypothesis variable** **Franchise businesses** **Purchased businesses** **New businesses**

*Note.* All comparisons are made to franchised businesses.

\*\*\* $p < .001$ .

2a, 2b	Revenues			
	<i>N</i>	51	95	1694
	Mean	\$741,058.20	\$806,770	\$124,475.00
	( <i>SD</i> )	(\$2,854,593)	(\$2,960,838)	(\$642,663.80)
	Median	\$88,000	\$125,000	\$24,000
	<i>F</i>		0.02	29.64***
2c, 2d	Labor Intensity			
	<i>N</i>	35	59	575
	Mean	26.70%	25.86%	26.79%
	( <i>SD</i> )	(22.09%)	(22.48%)	(26.07%)

**TABLE 2 Results of ANOVA for Hypothesis 2**

Hypothesis	Hypothesis variable	Franchise businesses	Purchased businesses	New businesses
	Median	25.00%	20.00%	20.00%
	<i>F</i>		0.03	0.00

Table 2 shows the revenue mean, median, and standard deviation for each of the three types of businesses. Franchisees reported a mean revenue in their first year of more than \$741,000, whereas new independent businesses had a mean first-year revenue of just slightly more than \$124,000, confirming Hypothesis 2a. However, purchased independent businesses had a reported mean first-year revenue of more than \$806,000 that was not significant different from that of franchisees. Therefore, Hypothesis 2b was rejected.

We also predicted in Hypotheses 2c and 2d that franchisees would have lower wage expenses relative to total revenues generated. Analyses found no group differences (both with  $F = .00$  and  $F = .03$ , respectively). Table 2 also shows that labor to total revenue ratios across the three types of businesses were not significantly different (26.70% for franchisees, 26.79% for new independent businesses, and 25.86% for purchased existing independent businesses). Therefore, Hypotheses 2c and 2d were rejected.

We also tested whether franchisees were more likely to have a profit in their first year than new independent businesses (Hypothesis 3a) and purchased existing independent businesses (Hypothesis 3b). We found that there were significant differences between franchisees and new independent businesses ( $\chi^2 = 10.05$ ,  $p < .01$ ) and franchisees and purchased existing independent businesses ( $\chi^2 = 4.17$ ,  $p < .05$ ). However, new independent businesses were actually more likely to have a profit in their first year in operation (48.37%) compared to franchisees (30.38%). Hypothesis 3a was rejected. Purchased independent businesses were also more likely to have a profit in their first year of operation (44.62%) compared to franchisees (30.38%). Hypothesis 3b was rejected.

Finally, we predicted that franchisees, including co-owners, were more likely to be serial entrepreneurs than new independent business owners and purchased existing independent business owners. No significant differences were found between franchisees, new independent business owners, and purchased existing independent business owners. Forty-one percent to 43 percent of businesses reported prior ownership experience.

## DISCUSSION

### Franchising Research

The results of this study have direct implications for research on franchising. The results reveal important, and previously undiscovered, differences among franchises, purchased existing independent businesses, and new independent businesses. Overall, franchises differ considerably from new, independent businesses in most respects but are rather similar to purchased existing independent businesses. Those lacking prior entrepreneurial experience are equally likely to pursue each of the three business ownership formats. Our results indicate that franchises do not provide a straightforward financial advantage over purchased or new independent businesses in the first year of operation. Franchisees were less likely to be profitable than both purchased existing and new independent businesses; they had equal labor intensity expenses to both new and purchased existing independent businesses; and although they had higher revenues than new independent businesses, they had considerably (although not significantly) lower revenues than purchased existing new businesses.

### Franchising Practitioners



Individuals drawn to franchise-based entrepreneurship should also consider the purchase of an existing business that normally has an established customer base without the franchise fee and contracts. A comparison and realistic projection of costs should be done for at least the first 5 years. The advantages of franchising in terms of a higher rate of survival and success are brought into question in this study. While the study is exploratory and limited based on one point in time, the results warrant further exploration in terms of the advantages and disadvantages of franchising compared to purchased existing businesses and new independent businesses.

## Research Limitations

One major research limitation is that the KFS data are highly focused on high-tech firms. Also, this data analysis is limited to one database in one particular year (2004), and a finite number of variables were examined. KFS has now made 2004 to 2008 data available, which will facilitate longitudinal data analysis including ascertaining the critical factors leading to a successful franchise startup.

Another major limitation is that the database is only U.S. businesses. Additionally, no information is given on the type of franchised businesses or for the independent and purchased existing independent businesses other than that they can fit within a particular industry. Other information that was not contained in the database is operating versus non-operating partners in the ownership category that would have resulted in a stronger comparison between franchised and the purchase of an existing business.

## Future Studies

Future studies could compare a wider range of types of firms to include and categorize the types of businesses. Retail businesses could be compared to categories of non-retail businesses. The results with U.S. firms could be compared internationally with samples in other countries to see whether the results are comparable and whether we can generalize from country to country on the variables used. Industrialized versus emerging countries could also be compared on these variables that may help us determine how to improve the survival rates of these three types of businesses and what type has the greatest chance of success in emerging versus industrialized economies. Also, what other variables that we did not look at should be considered? Are these variables different in international markets, whether they are emerging countries or industrialized countries?

Additionally, it is predicted that more businesses will turn over in the next 10 years than any time in the history of the world because of the vast number of businesses started after WWII. Non-family members will purchase many of these existing businesses. Future studies could look at this phenomenon and compare success rates against other types of businesses, including franchised businesses. Franchised businesses will also be up for sale, and comparisons could be made between all types of purchased existing businesses. Finally, a longitudinal study comparing all types of businesses could offer insights on the long-term profitability and success factors of franchised compared categories of independent retail business startups.

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## Notes

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